# NORTHLAND REGIONAL COUNCIL COMMUNITY INVESTMENT FUND

## INVESTMENT REVIEW FOR THE QUARTER ENDING 30 JUNE 2015

ERIKSEN & ASSOCIATES LIMITED

***28 JULY 2015***

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# EXECUTIVE SUMMARY

## OVERALL

Eriksen & Associates Ltd (Eriksens) produces investment reviews of the Northland Regional Council Community Investment Fund (the Fund) on a quarterly basis. The following review is for the quarter ending 30 June 2015.

The primary goal of the Fund is to promote business development in Northland. The current asset mix is 55% income and 45% growth assets which was agreed at the August 2014 Audit & Risk meeting.

The Fund is invested with five investment managers in six separate funds:

| Asset Class | Manager | Fund | Benchmark |
|---|---|---|---|
| NZ Fixed Interest | Harbour | Income Fund | 70% Corporate A Grade Index/30% NZX50 |
| | Milford | Income Fund | NZX 90 Day Bank Bill + 1% p.a. |
| | Mint | Income Fund | NZ CPI + 4% p.a. |
| Australasian Equities | Milford | Active Growth Fund | NZX50 + 3% p.a. |
| Global Equities | Schroders | Real Return Fund | Australian CPI (trimmed mean) + 5% p.a. |
| | AMP Capital NZ | GMAF | NZ CPI + 5% p.a. |

The return requirement of the Fund is a real return of 4% per annum (assuming inflation of 2.5%) after tax (if any) and investment expenses, over the long term which is generally considered at least three to five years. The benchmark return for the Fund has been taken from the June 2015 quarter CPI results which was 0.8% per annum (annualised over three years). This gives a real return one year benchmark of 4.8% for this report.

During the quarter there have been no breaches of the SIPO and all investment managers have complied with their specific mandates. We note that Milford was under investigation from the FMA over some specific trades conducted by a portfolio manager several months ago. The parties settled for a fine of $1.1 million plus costs of $400,000. The FMA stated the investigation had not related to the security of client funds or assets. At this point we recommend retaining the investments in Milford since the liquidity risk and manager risks are low and the investment is fully protected by the independent custodian. We now rate Milford funds a hold (previously a buy). Whilst there is a slight reputational risk if the particular trader is taken to Court by the FMA this may take years to eventuate. Hence our hold rating at this point.

## INTRODUCTION

Eriksen & Associates Limited (Eriksens) were appointed investment advisors to the Fund in November 2012. This report is in accordance with the SIPO approved by Council in November 2013 and the recommendations approved by Council at the Audit and Risk meeting on 19 August 2014.

This review reports the investment returns for all cash, bonds and equities held by the Fund for the quarter to 30 June 2015. The financial year-end for the Fund is 30 June, thus year-to-date returns are the same as the one year returns. We have also included returns from 31 December 2012 as this is when the investment strategy for the Fund changed and investments were first made with Schroders and Milford. It gives a slightly longer period for analysis of returns.

The returns shown are based on the data supplied by the in-house investment team and statements supplied by AMP, Harbour, Milford, Mint, and Schroders as at 30 June 2015. The returns have been calculated from dollar returns and average assets held during the period. There may therefore be a discrepancy from the money weighted asset return if the amounts invested in a particular asset class have changed during a month. If available, the use of daily rather than monthly data might reduce this.

## PERFORMANCE

### MARKET PERFORMANCE

All the major equity markets we follow were down over the quarter with the exception being the Nikkei (Japan) and emerging markets, which returned 5.4% and 0.7%. The markets in Europe suffered the most, with the FTSE 100 (UK market) down 3.7%, the DAX (German market) down 8.5%, and the CAC 40 (French market) down 4.8%. The S&P 500 was down 0.2% over the quarter. Over the past 12 months all markets increased except for the FTSE 100 which returned -3.3%. The Nikkei advanced markedly with a return of 33.5%. The DAX and CAC made 11.3% and 8.3%, with the S&P 500 making 5.3% over the year.

The New Zealand equity market lost 1.8% over the quarter but gained 11.4% for the year. In Australia equities dropped 6.6% for the quarter but were up 5.7% for the year.

New Zealand government and investment grade bonds were up over the quarter and year. Global government and investment grade bonds were down over the quarter, but up over the twelve month period.

The New Zealand dollar has depreciated against all major currencies over the quarter and the twelve months to 30 June. Against the Australian dollar it fell 10.4% for the quarter and 5.1% over the year. This was beneficial to Australian denominated unhedged returns. The NZD dropped by 13.1% and 14.9% against the Euro and sterling for the quarter, and 5.1% and 16.0% for the year. It was down 9.8% against the US dollar for the quarter and 22.8% for the year.

The West Texas Crude Oil Index and Brent Crude Oil are both down over 40% in the 12 months to 30 June. Gold is also priced lower than it was a year ago but by 11.7%.

## FUND PERFORMANCE BY ASSET CLASS

### Overall

The Fund returned 2.3% over the quarter which outperformed the Fund's objective by 1.1%. The objective of 1.2% was calculated from the June 2015 annual CPI results for New Zealand. The CPI figures for June showed an annualized increase in inflation of 0.8% over a rolling three year period. This gives a quarter objective of 1.2% (being the fourth root) of 4.8%.

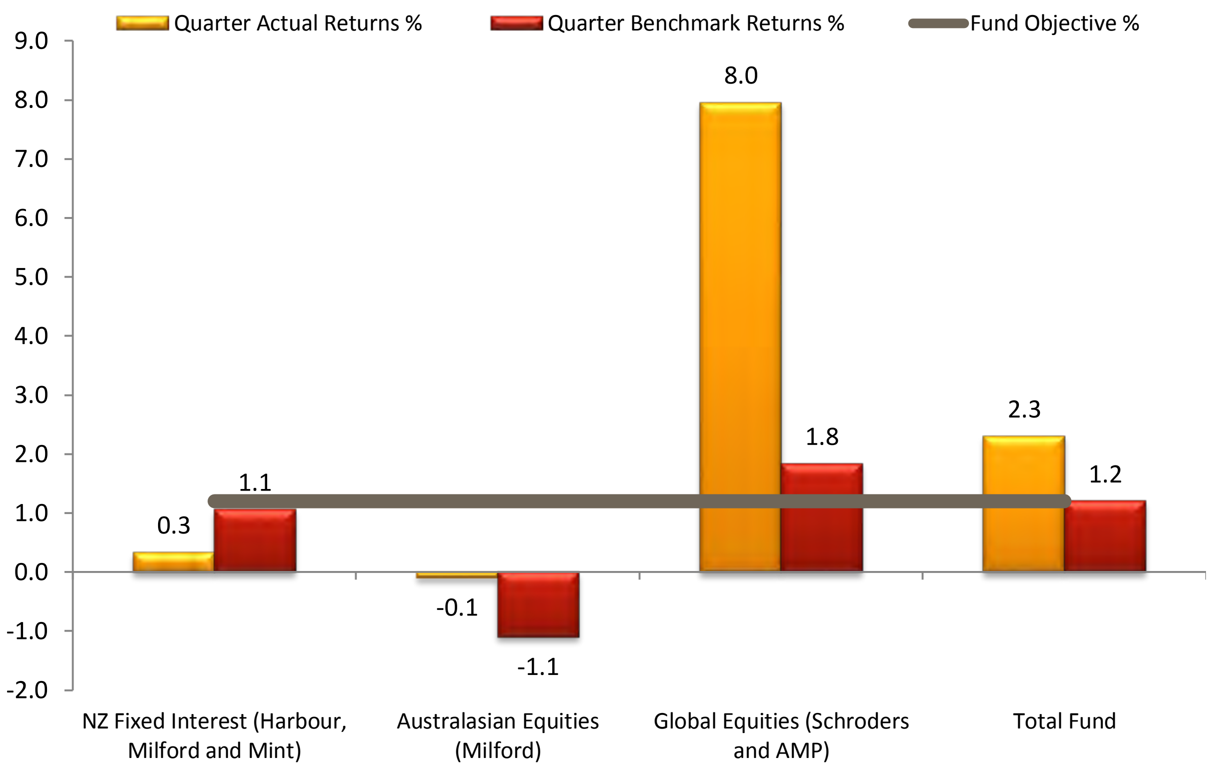
Over year it returned 11.2% which outperformed the objective of 4.8% by 6.4% (over double). Since inception (or two years and six months) it returned 8.8% annualised which was an outperformance of 4.4%, a great result.

| Asset Class | Quarter % | 1 Year % | Since Inception* (p.a.) % |
|---|---|---|---|
| **NZ Fixed Interest** | **0.3** | **10.8** | **10.0** |
| Benchmark (weighted average) | 1.1 | 6.2 | 4.3 |
| Over / Underperformance | -0.8 | 4.6 | 5.7 |
| **Australasian Equities** | **-0.1** | **12.8** | **15.0** |
| Benchmark | -1.1 | 14.7 | 18.1 |
| Over / Underperformance | 1.0 | -1.9 | -3.1 |
| **Global Equities** | **8.0** | **11.5** | **6.5** |
| Benchmark (weighted average) | 1.8 | 7.0 | 7.3 |
| Over / Underperformance | 6.2 | 4.5 | -0.8 |
| **Total Fund** | **2.3** | **11.2** | **8.8** |
| Fund Objective | 1.2 | 4.8 | 4.4 |
| Over / Underperformance | 1.1 | 6.4 | 4.4 |

*Inception date is 31 December 2012

The table above shows the quarter, one year and since inception (30 months) investment returns on the Fund's asset classes. The returns in each asset class are weighted by the individual assets within each class.

## Quarterly Returns by Asset Class




## NZ Fixed Interest

This asset class comprises Harbour's Income Fund, Milford's Income Fund and Mint's Income Fund.

The returns for the quarter relate to the performance of the Harbour, Milford and Mint funds however the one year returns and since inception returns include the performance of (the now sold) NZ bonds also.

The fixed interest asset class returned 0.3% for the quarter, underperforming the weighted average benchmark by 0.8%. The return over the year was 10.8%, outperforming the benchmark return by 4.6%, a pleasing result.

Since inception the asset class returned 10.0% per annum, outperforming by 5.7%. These are very good results and can mostly be attributed to the performance of Milford's Income Fund.

## Australasian Equities

Milford's Active Growth Fund outperformed the benchmark over the quarter by 1.0% with a return of -0.1%. Milford underperformed over the year with a return of 12.8% which was 1.9% below the benchmark. The return since inception was 15.0% per annum, 3.1% below benchmark.

## Global Equities

The global equities asset class consists of Schroders Real Return Fund and AMP's Global Multi-Asset Fund. The one year and since inception returns relate to Schroders' performance. The quarterly performance figures includes AMP and Schroders.

The investment with Schroders is denominated in Australian dollars and is unhedged. The investment in AMP is a 50%/50% split between Schroders Real Return Fund in Australia and AMP Australia's Multi-Asset Fund. The return on this investment is fully hedged to NZ dollars.

Over the quarter the global equities asset class returned 8.0%, outperforming the weighted average benchmark by 6.2%. Currency movements were largely beneficial to the Schroders return, with the New Zealand dollar falling significantly against the Australian dollar over the quarter.

The return for the year was 4.5% above the benchmark, returning 11.5%. Since inception the asset class returned 6.5% annualised which was an underperformance of 0.8% against the weighted average benchmark return. Again, the weak Kiwi dollar versus the Australian dollar over the year aided the returns from Schroders as this asset is unhedged.

The table below shows the returns for Schroders in New Zealand and Australian dollar terms:

| Schroders Real Return Fund | Quarter Return % | | | 1 Year Return % | | |
|---|---|---|---|---|---|---|
| | **Gross** | **Bench mark** | **Value Added** | **Gross** | **Bench mark** | **Value Added** |
| NZD Return | 9.8 | 1.9 | **7.9** | 12.1 | 7.4 | **4.7** |
| AUD Return | -1.5 | 1.9 | **-3.4** | 7.1 | 7.4 | **-0.3** |

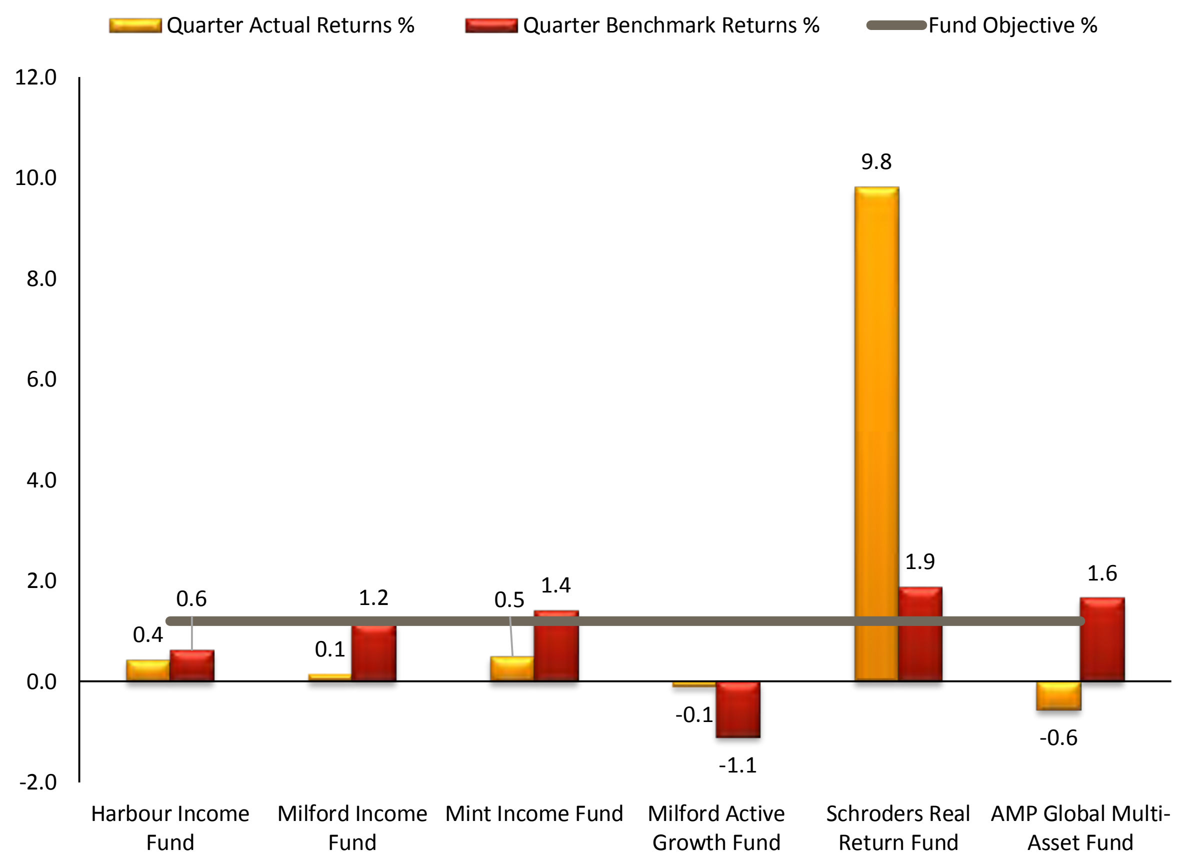
## FUND PERFORMANCE BY INDIVIDUAL MANAGER

The table below shows the individual market values and asset returns for the quarter, one year and since inception periods.

| Asset | Quarter % | 1 Year % | Since Inception* (p.a.) % |
|---|---|---|---|
| **NZ Fixed Interest** | | | |
| **Harbour Income Fund** | **0.4** | **9.6** | **n/a** |
| Benchmark (70% Corp A + 30% NZX50) | 0.6 | 9.3 | 8.1 |
| Over / Underperformance | -0.2 | 0.3 | n/a |
| **Milford Income Fund** | **0.1** | **12.8** | **n/a** |
| Benchmark (90 Day Bank Bill + 1% p.a.) | 1.2 | 4.8 | 4.2 |
| Over / Underperformance | -1.1 | 8.0 | n/a |
| **Mint Income Fund** | **0.5** | **n/a** | **n/a** |
| Benchmark (NZ CPI + 4% p.a.) | 1.4 | 4.3 | 4.4 |
| Over / Underperformance | -0.9 | n/a | n/a |
| **Australasian Equities** | | | |
| **Milford Active Growth Fund** | **-0.1** | **12.8** | **15.0** |
| Benchmark (NZX50 + 3% p.a.) | -1.1 | 14.7 | 18.1 |
| Over / Underperformance | 1.0 | -1.9 | -3.1 |
| **Global Equities** | | | |
| **Schroders Real Return Fund** | **9.8** | **12.1** | **6.3** |
| Benchmark (Aus CPI trimmed mean + 5% p.a.) | 1.9 | 7.4 | 7.5 |
| Over / Underperformance | 7.9 | 4.7 | -1.2 |
| **AMP Global Multi-Asset Fund** | **-0.6** | **7.8** | **n/a** |
| Benchmark (NZ CPI + 5% p.a.) | 1.6 | 5.3 | 5.4 |
| Over / Underperformance | -2.2 | 2.5 | n/a |
| **Total Assets** | | | |
| **Total Fund** | **2.3** | **11.2** | **8.8** |
| Fund Objective | 1.2 | 4.8 | 4.4 |
| Over / Underperformance | 1.1 | 6.4 | 4.4 |

*Inception date is 31 December 2012

## Quarterly Returns by Individual Manager



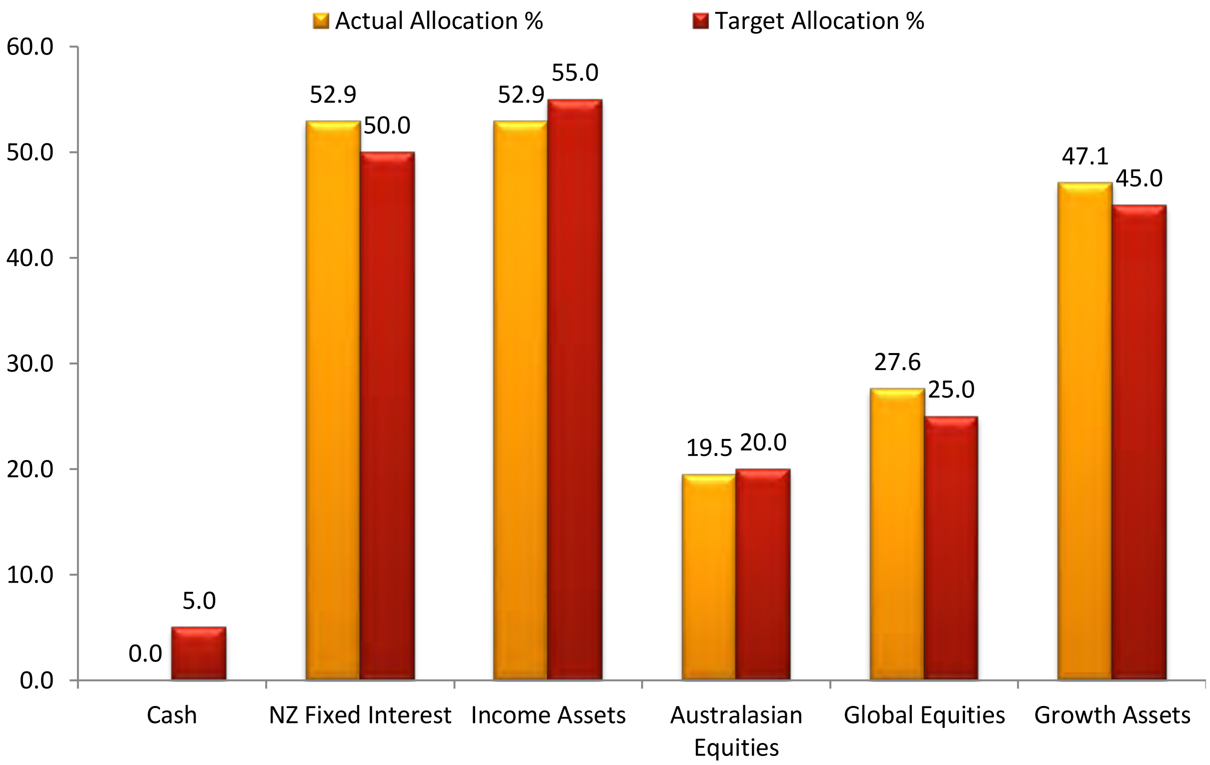

## ERIKSEN'S INVESTMENT MANAGER AND FUND RATINGS

The table below summarises Eriksen's rating of each of the underlying funds the NRC CIF is invested with. All funds are rated 4 or 5 which means that we recommend the investment should either be kept in the portfolio or more should be purchased. These ratings are generalised, so although we have rated some as 5/Buys we are not recommending the Council invests more in these funds as the proportion invested is sufficient. Please see the Appendix for a detailed explanation of the methodology.

| Manager | Fund | Rating |
|---|---|---|
| AMP Capital | Global Multi-Asset Fund | 5/Buy |
| Harbour Asset Management | Income Fund | 4/Buy |
| Milford Asset Management | Active Growth Fund | Adjusted 4/Hold |
| Milford Asset Management | Income Fund | Adjusted 4/Hold |
| Mint Asset Management | Income Fund | Adjusted 4/Buy |
| Schroders | Real Return Fund | 5/Buy |

## ASSET ALLOCATIONS

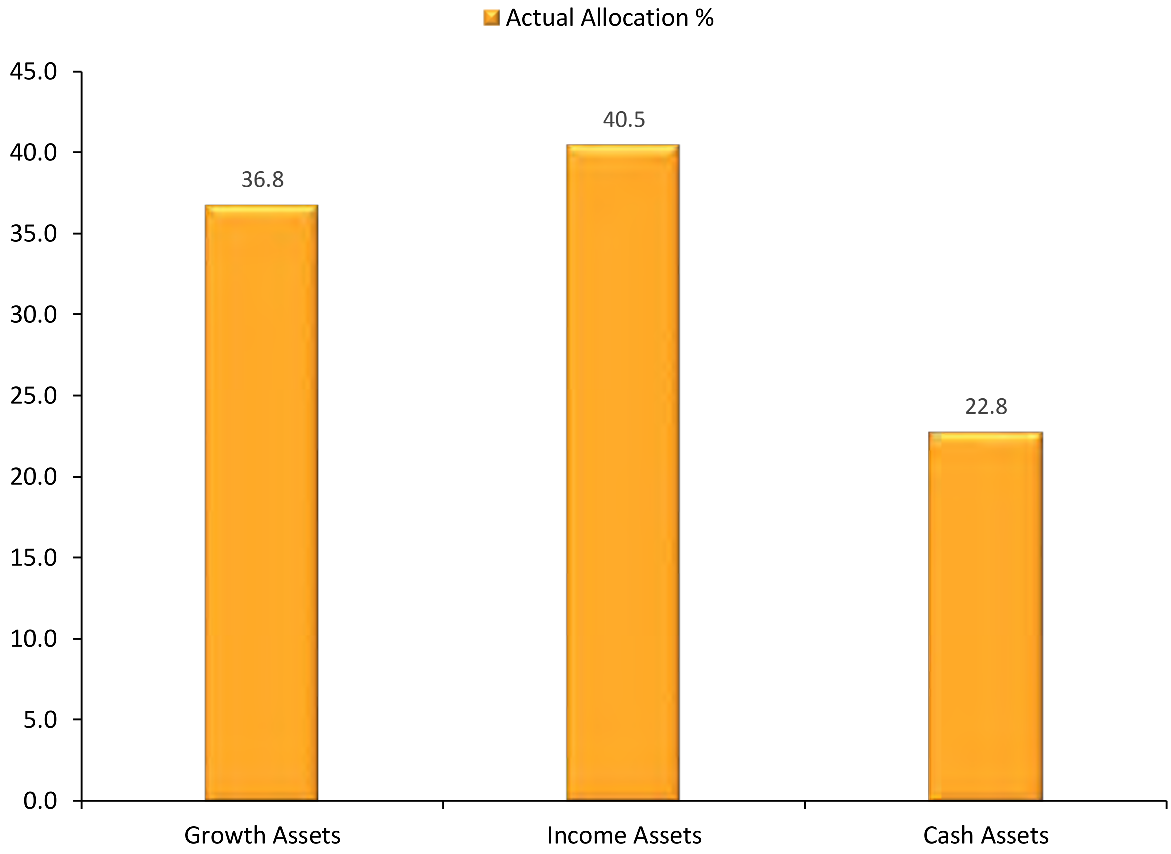
The Fund's asset allocations at 30 June 2015 are shown below:




The Fund's asset allocation shows all asset classes are within the ranges as specified by the SIPO. The split between income and growth assets is within the target range. All asset classes are close to their targets.

| Allocations | | Market Value NZ$ | Actual Allocation % | Target Allocation % | Difference % | Status |
|---|---|---|---|---|---|---|
| Cash | | - | 0.0 | 0 < 5 < 40 | -5.0 | ✓ |
| Harbour Income Fund | 1,938,962 | | | | | |
| Milford Income Fund | 2,563,241 | | | | | |
| Mint Income Fund | 1,726,817 | | | | | |
| NZ Fixed Interest | | **6,229,021** | **52.9** | **30 < 50 < 70** | **2.9** | ✓ |
| **Income Assets** | | **6,229,021** | **52.9** | **35 < 55 < 75** | **-2.1** | ✓ |
| Milford Active Growth Fund | 2,293,207 | | | | | |
| Australasian Equities | | **2,293,207** | **19.5** | **10 < 20 < 30** | **-0.5** | ✓ |
| Schroders Real Return Fund | 2,693,254 | | | | | |
| AMP Global Multi-Asset Fund | 555,887 | | | | | |
| Global Equities | | **3,249,142** | **27.6** | **15 < 25 < 35** | **2.6** | ✓ |
| **Growth Assets** | | **5,542,348** | **47.1** | **25 < 45 < 65** | **2.1** | ✓ |
| **Total Assets** | | **11,771,369** | **100.0** | | | |

The Fund's asset allocation split by underlying fund assets is shown below:




Growth assets includes:

- Global shares
- Australasian shares
- Property

Income assets includes:

- Global bonds
- Australasian bonds
- Other debt instruments

Cash assets means cash or short duration bonds.

Over the quarter there was a decrease in both income and growth assets, and an increase in cash assets, reflecting the volatile nature of the markets and geo-political risks at present.

## ECONOMIC COMMENTARY

In the second week of July 2015 global financial markets were delicately balanced.

Although the consequences of the "No Vote" in the Greek referendum the previous weekend were getting the publicity, what is going on in China probably has more relevance for both Australia and New Zealand. Around the world long term interest rates in the US and Germany were going down as investors sought safe havens. At the same time stock markets sold off. Normally when interest rates go down stock markets go up because companies can access cheaper working capital. Clearly some bubbles are deflating if not bursting as was the Chinese stock market.

However over the next weekend the Chinese stock market bounced back so did the US, UK and European markets. This was based on the hope that a fresh Greek bail out would be negotiated as Mr Tsipras the Greek Prime Minister submitted revised austerity measures to the European Union. Janet Yellen of the Federal Reverse advised that a rise in US interest rates was still scheduled for later this year. So this time we had long term interest rates rising and stock markets going up at the same time.

Confused? Well clearly so are the markets. With volatility also rising (the ten year German Bund up 25% in a day) the rest of the year is going to be interesting for long term investors.

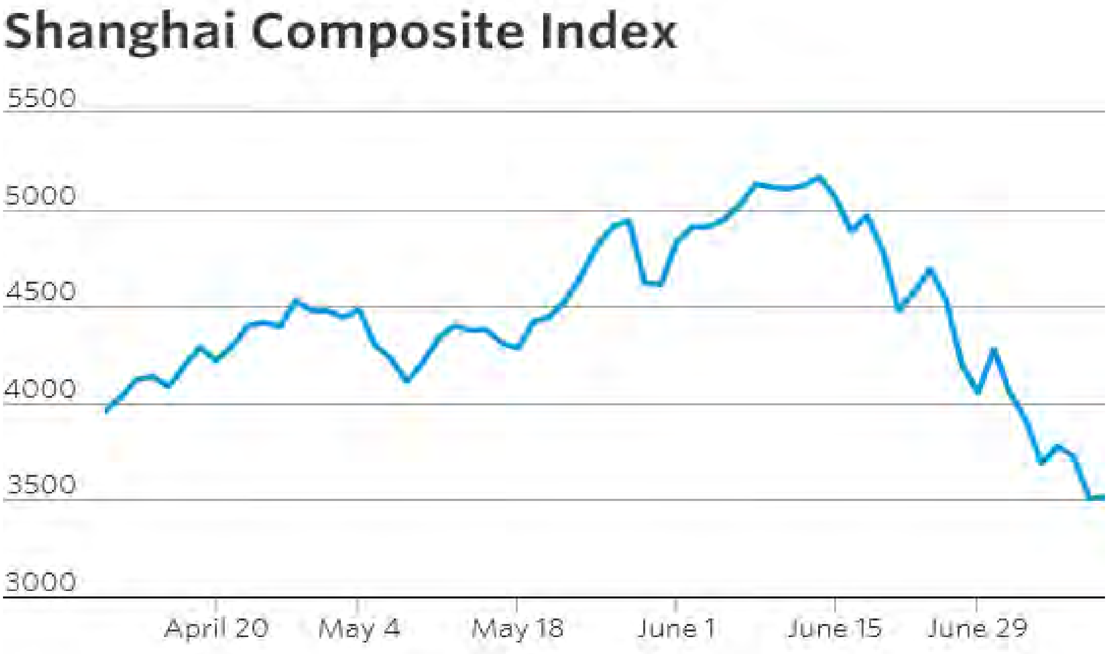
Although there are indications that growth has returned to most of the advanced economies, the global economy is still in a vulnerable state. On the positive side the threat of deflation appears to have receded, the US still looks likely to raise its interest rates this year and the IMF has been forecasting that growth will still exceed 2% in the developed countries during 2015.

On the negative side China's growth is slowing, while Russia and Brazil are in recession. Markets are volatile and remain subject to sharp fluctuations. Monetary policy remains loose in the wealthier economies, with low interest rates being seemingly impossible to raise without risking recession. Low rates have not only encouraged high borrowing for consumer spending, but they have also encouraged people to borrow large amounts to buy property and shares. Not only has this fed into sharp increases in asset values, with high house prices being of special concern in New Zealand and elsewhere – but it has also led to a situation where an increase in rates could potentially compromise borrowers' ability to service their debts – with any resulting selloffs leading to a price crash which might compromise various countries' banking systems. As a result policy makers have been forced to keep interest rates low, with any rises being modest, and well signalled in advance. This of course leaves policymakers with little scope to further reduce rates in the event of another downturn.

**China**

China has been a growing concern. Since mid-June more than US$3 trillion has been wiped from the Chinese markets. Previous to this the Shanghai market had been up 150%. The latest sell-off could be taken as a return of share prices to their true underlying values. Nevertheless, the government in

China seems to be stimulating the bubble. Interest rate cuts have made it easier for investors to take on more leverage, and market perceptions are that President Xi will continue to attempt to keep the market aloft with the full power of the state.




A prolonged sell-off would knock business and household confidence, impacting overall consumption in China. This is a major concern for exporting countries to China, namely New Zealand and Australia. Iron ore prices are at their lowest since 2009, which is having devastating effects on Australia's economy. It is not just iron ore that is down. Aluminium is at a six-year low, and the prices of gold, wheat, zinc, corn, cotton and copper are also down due to concerns about the muscle of the Chinese economy at present. Nevertheless we expect the Reserve Bank of Australia to keep interest rates on hold for now.

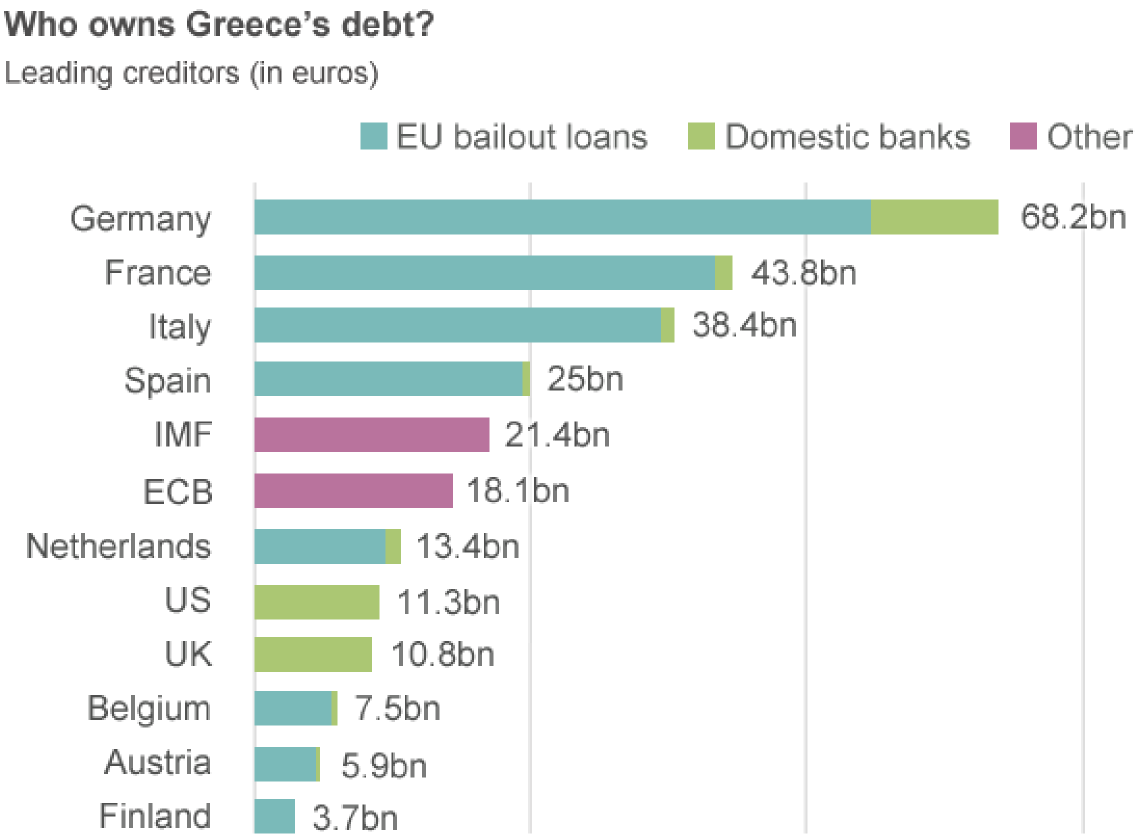
Last year 19% of New Zealand's exports went to China. The current situation in China and potential drop in consumption has an important impact on global milk prices. The average Global Dairy Trade dairy price is 32.5% lower than it was in early March. The outlook is weak, with demand subdued but production remaining high. Large deferred payments from a strong 2013-2014 season suggest headline payouts for dairy farmers are not as grave for future cash flows.

The depreciating NZ dollar will also soften the blow from lower dairy prices. On June 11 the Reserve Bank lowered the OCR contrary to many analysts' forecasts. Combine this with weaker than expected domestic data, increased risk aversion, expected US monetary policy tightening and the New Zealand dollar which has dropped against all major currencies over the last quarter. The Reserve Bank maintains an easing bias, with analysts picking another two cuts to the OCR before the year is out.

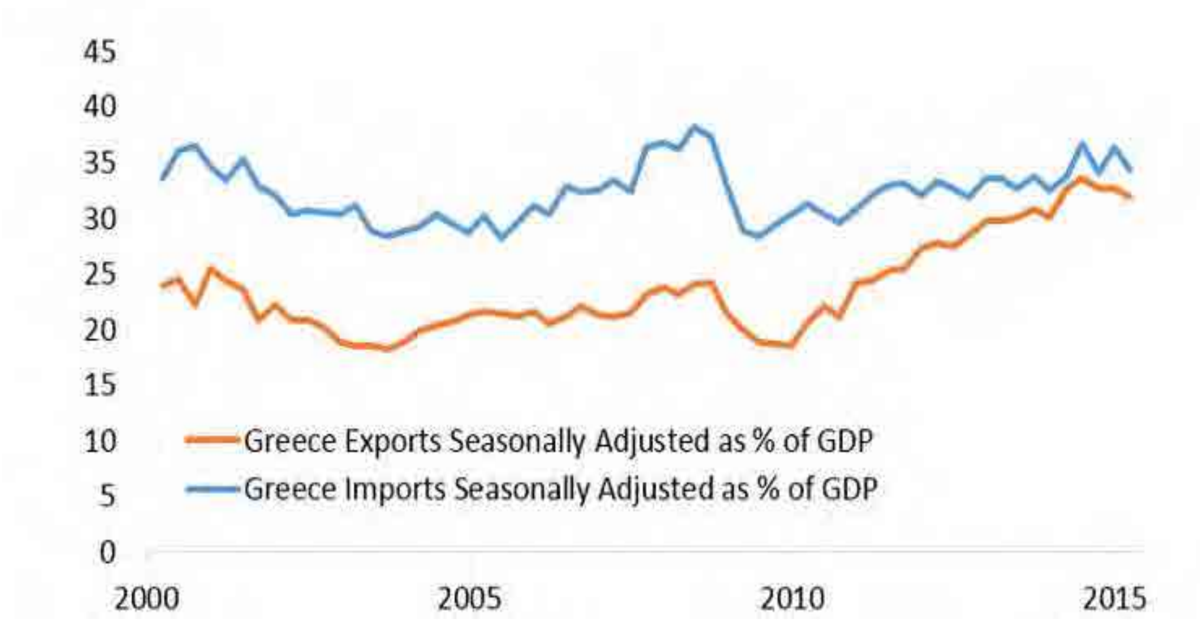
**Greece**

The complex scenario in Greece continues, with neither side agreeing to each other's proposed package of reforms. The crisis developed over June with Greece asking the IMF to postpone a repayment till the end of the month, by the time this rolled around the crisis went from bad to worse with Greece defaulting and falling into arrears. A referendum was held the following week with over 61% of votes against the proposed measures suggested by the EU.

One of the main fears of the escalating Greece debt crisis and a potential Greek exit (Grexit) from the Eurozone is contagion across Europe. Seen in the graph below, several of the major countries in Europe are among Greece's leading creditors. If they do exit the Eurozone this could undermine the credibility of the euro. Weaker countries such as Portugal and Italy would be more risky to investors, meaning higher interest rates for this perceived extra risk.




Leaving the Eurozone is not supposed to happen, once you are in you are in. If Greece leave and their economy thrives, further down the track countries in the Eurozone who are struggling may see this as a credible alternative. It is unlikely the Greek economy would thrive in this situation. An exit would likely mean a return to the drachma, subsequent devaluation of the currency, and default on euro-denominated loans. Imports would become more expensive, companies who owe foreigners would go bankrupt. Nobody would want to lend to Greece, tax revenues would drop and the central bank would be forced to print money, causing inflation to spiral out of control. The Greek economy is largely inward looking with imports outnumbering the amount of exports. For Greece to thrive after a devaluation of their currency this needs to be the other way around, Argentina in 2001 being an example with its strong agriculture exports.




The base scenario for many analysts is for a Greek exit from the Eurozone, particularly with a resounding 'no' vote in the referendum. Globally it is hard to escape the noise created by the debt crisis, although, because of the sluggish nature of the negotiations going on the financial markets seem to have priced in much of this over the month and quarter and have been well-prepared for negative news on Greece.

The effect on New Zealand is likely to be minor with the EU only buying 10% of NZ exports and Greece only making up 2% of the European economy. However, if these events are combined with possible geo political events which spook the markets further who knows what may happen?

# APPENDIX: ERIKSEN'S FUND MANAGER RATING METHODOLOGY

Our rating scale for Fund Managers is explained below. Please note that this assessment is proprietary information and is for the use of Eriksens and our clients only. We ask that it not be discussed or shared with the fund manager in question without our express prior permission.

After a full qualitative and quantitative analysis Eriksens' assign a numerical rating from -1 to 2 across the key areas of:

- Philosophy & Idea Generation
- Process
- People
- Performance
- Portfolio Structure & Composition
- Business Considerations
- Client Support & Administration

These numerical assessments are as follows:

| Rating | Explanation |
|---|---|
| -1 | The manager is critically deficient in this area and does not meet expectation or specific requirements, urgent changes are needed |
| 0 | The manager is somewhat deficient in this area and may need some changes but not immediately |
| 1 | The manager is competent in this area and displays some competitive advantages but could improve in order to become class-leading, generally there are better choices of manager available |
| 2 | The manager is fully competent in this area, displays definite competitive advantages and is a class leader |

These ratings per area are then added together, along with an overriding qualitative judgment process to determine an overall rating, which ranges from 1 to 5. A "1" rating represents a manager not ready to be rated, and "5" a manager that is fully competent in all aspects and has competitive advantage.

We also assign short-term ratings to the funds, which consist of either Buy or Sell or Hold. As expected a 5 rated manager's fund would generally (but not always) be Buy rated, a 4 rated manager's fund generally a Hold, and 1, 2, and 3 rated manager's funds would normally be a Sell.

These ratings are explained in the table below:

| Rating | Explanation |
|---|---|
| Sell (1,2 & 3 rated Managers) | A *"1"* rated manager is usually *"Not Rated"* rather than a *"Sell"* due to lack of capability in too many aspects of their business and should not be included in portfolios in the first instance. *"Sell/2"* managers are critically deficient and *"Sell/3"* managers are somewhat deficient across various parts of their business. Any monies with them should be removed, as there are more attractive managers with higher ability to consistently add value. |
| Hold (4 rated managers) | The manager is generally competent in all areas of their business and may need some changes but not immediately. They may also be working towards making these changes. Existing monies should be kept with them but no new mandates in general should be awarded. |
| Buy (5 rated managers) | The manager is fully competent in all areas of their business, displays definite competitive advantages and is a class leader. New mandates should automatically be awarded to this manager, as they will add definite value to a client's portfolio. |

Managers are reviewed on a quarterly basis with a full assessment conducted annually.